

IX. EVALUATION OF REGULATORY STRUCTURE

Overview

There is no single state agency that has the full responsibility for regulating workers' compensation insurance in California. Rather responsibility for regulating insurance companies doing business in the state (including workers' compensation) is the jurisdiction of the Insurance Commissioner and the CDI. The responsibility for regulating and enforcing workers' compensation laws, adjudicating disputed workers' compensation claims, authorizing employers to self insure workers' compensation liabilities and preventing industrial injuries falls to the Department of Industrial Relations. In addition, there is the semi-autonomous State Compensation Insurance Fund (SCIF), the largest workers' compensation carrier in the state, which is governed by a Board of Trustees.

The regulatory division between carriers under CDI and self insured employers under DIR seems to be clear. Each department has broad regulatory authority over their areas of jurisdiction: insurance companies under the Insurance Code, self-insured employers under the Labor Code. DIR basically is the regulatory agency for matters involving workers' compensation benefits and claim disputes under the Labor Code.

Insurance Commissioner

The Insurance Commissioner is a statewide elected official tasked with enforcing the California Insurance Code, regulating the insurance industry, and overseeing the Department of Insurance.¹

California Department of Insurance (CDI)

The Department of Insurance oversees the \$115 billion in direct written premiums insurance market (the workers' compensation portion of the total according to the CHSWC was \$23.6 billion in 2004). CDI conducts examinations and investigations of insurance companies and brokers and agents (producers) to ensure that operations are consistent with the requirements of the Insurance Code and that insurance carriers are financially able to meet their obligations to policyholders and claimants,. The Department investigates complaints, and responds to consumer inquiries, administers the conservation and liquidation of insolvent and delinquent insurance companies, reviews and approves insurance rates, and works to combat insurance fraud. Approximately 1100 personnel are employed in the Department with an annual budget of approximately \$202M in fiscal year 2005.²

WCIRB

Assisting the Department of Insurance is its statistical agent, the Workers' Compensation Insurance Rating Bureau (WCIRB). The WCIRB is an unincorporated, non-profit association of all companies licensed to transact workers' compensation insurance in California, which collects data from member companies to produce advisory pure premium rates using complex statistical and actuarial techniques, as well as preparing experience modification for eligible employers.

Approximately 200 personnel are employed and its annual budget is from member company fees and assessments.³

The Department of Industrial Relations (DIR)

The Department of Industrial Relations is headed by a director, appointed by the Governor and confirmed by the Senate. The three major programs in the Department are (1) occupational safety and health, (2) wages and working conditions, and (3) workers compensation. Most of the regulatory authority over workers' compensation is not vested with the Director of Industrial Relations, but rather with the Administrative Director, the head of the Division of Workers' Compensation. The Administrative Director is also appointed by the Governor and confirmed by the Senate.

The DWC has responsibility to monitor administration of workers' compensation claims, minimize disputes through information and assistance, provide administrative and judicial services to resolve claim disputes involving workers' compensation benefits, audit workers' compensation claims administrators to ensure Labor Code benefits are delivered, pay benefits to injured workers from Uninsured Employers Trust Fund and Subsequent Injuries Benefits Trust Funds, and manage a information system on the benefit delivery system. Also, part of DWC is the Workers' Compensation Appeals Board (WCAB), which reviews petitions for reconsideration of decisions of the workers' compensation law judges of the DWC and regulates the adjudication process. Approximately 1100 personnel are employed by DWC with an annual budget of \$154 M in 2005.⁴

Also in the Department of Industrial Relations are three related programs:

Self-Insurance Plans which regulates the self insured employers' portion of workers' compensation, reporting to the Director of Industrial Relations, with a staff of approximately 25 personnel and an annual budget of approximately \$3.5M in 2005.⁵

The Commission on Health, Safety and Workers' Compensation (CHSWC), an independent Commission of labor and management representatives, that is responsible to issue an annual report on the state of the workers' compensation system, including recommendations for improvement in the operation of the workers' compensation system; conduct surveys and evaluations required by statute; and to continually examine both the workers' compensation system and the occupational safety and health prevention activities to recommend improvements. The Commission employs approximately 19 personnel and has an annual budget of approximately \$3.1M in 2005.⁶

Division of Occupational Safety and Health which enforces workplace safety and health regulations investigates causes of occupational deaths and injuries and helps maintain safe and healthful working conditions. The Cal/OSHA Program, including the its regulation setting board and appeals board has a staff of approximately 700 personnel and an annual budget of \$85.4 M in 2005.⁷

DIR/DWC REGULATORY OVERSIGHT

When there is a major reform of workers' compensation eligibility or benefit statutes, there will be any number of necessary regulatory follow-up activities undertaken by one or more of these agencies. Generally the most impacted agency in terms of regulatory activities is the Division of Workers' Compensation. With respect to the reforms being studied in this report, in the "2004 Annual Report" by CHSWC listed eleven (11) statutory sections that required regulatory action by DIR or DWC as a direct result of the passage of AB-749; seventeen (17) additional statutory sections that required regulatory action as a direct result of passage of AB227 and SB228 in 2003; and eleven (11) more statutory sections that required regulatory action with the passage of SB899 in 2004. CHSWC's "List of Division of Workers' Compensation Regulatory Action Pursuant to Workers Compensation Reform Legislation" is reproduced in Appendix L. Such a list of regulatory actions is a formidable task for any state agency to accomplish, but when major statutory reform occurs, the nature of many of the subsequent regulatory actions can make the task all the more challenging when the regulations must venture into previously unregulated areas as is certainly the case with the reforms enacted in 2002, 2003, and 2004. In addition, many of the new regulations will require regular updating (such as each of the new fee schedules) to stay current, requiring further regular rulemaking activities by the DWC.

The recent reform legislation has placed a particularly large regulatory burden on the DWC to expand its regulatory activities to implement the reforms. The extent of the reforms will require DWC to maintain a much higher level of ongoing regulatory activities in the future, for which they may not be adequately be staffed in terms of numbers and areas of expertise. For example, the expanded use of fee schedules brings with it a commitment to ongoing regulatory activities by the DWC to keep the schedules current with costs. In addition, the medical provider networks bring a whole new industry under regulation by the DWC. While the MPN's are a means to control medical costs and utilization in the workers' compensation system, our initial research on MPN's suggests that this new industry which oversees the medical costs and utilization review process also approves medical bills and utilization being charged by medical professionals in the networks. This may create conflicts of interest that will need to be addressed at some point, particularly if there are only a handful of large MPN's that dominate this new field of commerce.

Regulatory Unit in DWC

With such an increase in regulatory activities and the need for regular updating of its regulations caused by the reforms, DWC might benefit from the creation of a regulatory unit, specialized in the preparation of rulemaking files, conducting public hearings, and the adoption of administrative regulations under the Government Code, as it would appear that the DWC will have an steady, ongoing regulatory agenda as a result of the reforms for the indefinite future. It is important to note that potentially millions of dollars of fees or reimbursements to the vendors within the workers' compensation system will ride on many of the future updates to just the fee schedules alone. One should anticipate that all affected parties will actively participate in future regulatory activities, which will make rulemaking by consensus difficult. Thus, the DWC

regulatory unit will need to be properly trained, staffed, and able to adopt final regulations after contentious public hearings.

DWC Process Reforms

One of the more interesting potential reforms that could impact DWC is the expansion of the carve-outs to every industry that wishes to make use of it. The carve-out program permits labor and management in an industry to resolve disputes outside of the traditional dispute resolution process of adjudication before the DWC. On the one hand, carve-outs hold the promise of streamlined dispute resolution benefiting both the carrier/self insurer and the injured worker. At the same time, carve-outs take the dispute resolution business away from DWC. It would seem reasonable that DWC would want to retain as much of the dispute resolution business as possible. However, in order to do so, DWC will need to reform its own internal system of adjudication to speed up its production of decisions in all matters before it, or risk a substantial loss of business to alternate methods of dispute resolution in carve outs. It would seem that the DWC would want to embrace as “paperless” a process as possible, fully utilizing both the internet and computers for forms, filings, legal service, scheduling of hearings, and issuing of decisions. Considering how fundamental some of the new reforms are to the workers’ compensation system, this might be an appropriate time for DWC to conduct a study of possible process reforms for managing its ongoing workload and production of decisions. Injured workers, carriers, self-insurers and all the vendors in the workers’ compensation system could benefit from DWC implementing an improved means of managing and conducting their dispute adjudication business.

REGULATORY ROLE OF CDI

The Insurance Commissioner and CDI have had a dual role since the advent of open rating in 1995. For the past 80 years prior to open rating, the minimum rate law protected insurers by establishing a rate floor (established by the WCIRB). This rating system practically guaranteed that insurers would earn profits. Insolvencies were rare and generally the result of extreme mismanagement. Thus, in the workers’ compensation market, CDI focused more on the issues of rate excessiveness or unfair discriminatory practices. Reasonable levels of competition existed due to the controlled pricing environment. Scarcity of insurers generally only occurred with other lines or other states became more attractive to the insurers, who as a result would redirect capital to those other areas. And SCIF was always the safety value in such instances, since it was, and remains, the residual market (the market required to insure any employers rejected by the private insurers). SCIF’s market share was always below the 20% level throughout this period, prior to open rating.

Since the open rating system, the WCIRB only developed “pure premium” rates (loss and loss expense costs). Insurers were required to file rating plans and the range of rate deviations that they intended to use, but then were free to set the price on individual policies with little or no oversight or control by CDI. As a result of the inaccurate projections of claims costs throughout the late 1990’s and into the early 2000’s, reinsurance failures or disputes, and overly aggressive pricing by insurers, the market essentially collapsed (resulting in SCIF becoming the predominate insurer with nearly 60% market share in 2003). During this time CDI’s role

expanded dramatically (along with insurance regulators in other states with domiciled insurer who failed) in the monitoring and management of many failed insurers.

Immediately prior to the reforms, there were upward adjustments to the rates proposed by the WCIRB and approved by CDI. However, by that point in time there had been a substantial withdrawal by major insurers from the California market. With the passage of AB 749, with components of the bill relating to medical cost containment that were advocated by the Insurance Commissioner among many others, the pendulum swung to the side of rate control through exhortations to private insurers and SCIF to reduce rates in anticipation of future cost savings. Insurers, however, could not be forced by CDI to reduce rates even if the CDI approved rates were reduced. Under the new open competition system, the free market would set the ultimate price. The situation became even more pronounced with the passage of the additional reforms in 2003 and 2004. The Commissioner and CDI continued to advocate for lower premiums in anticipation of even greater savings (which are in fact being estimated, as discussed in Section II of this report).

The recent past indicates that open competition poses risks to the insurance regulator and the insurance industry. An overheated market, fueled by the promise of low loss ratios, strong investment gains, or cheap reinsurance, could once again result in insurers competing for market share in order to maintain cash flow (for investment income as opposed to underwriting profits). Thus, it important for the regulatory system to prevent *excessive* pricing while at the same time preventing *inadequate* pricing. Both are issues more critical in the “soft” market which has emerged since the reforms.

If various affected organizations were asked “How well did the regulatory process work in the past?” the answers would be very different. From the Board of Trustees at CIGA the answer might likely be “Not very well—28 workers’ compensation carriers became insolvent with a cost to CIGA of several billion dollars”. These amounts will have to be paid by employers who buy workers’ compensation coverage in the future through a “CIGA Surcharge” added to the premiums of all workers’ compensation policyholders.(currently 2% of the annual policy premium)”

Pose the same question to SCIF, the largest carrier in the state, and it might say “SCIF has done well, but it was not without some difficulties along the way”. It has regained its financial solvency (now with \$3.5 billion in surplus at September 30, 2005, up from \$1.5 billion at year end 2003) and was able to handle the huge influx of business that occurred from 2000 to 2004.

Pose the question to California employers and there will not likely be many that with kind words for how well the system has performed until recently (as evidenced by the Employer Survey results in Section VI). Rates remain high relatively (particularly in relation to other states in the western United States) and certain types of industries have not seen the competitive market return (also cited in Section VI).

The Rate Study Commission report issued in 1992 contained various recommendations that led to “open rating”. However, certain key recommendations were not acted upon. The Commission recommended a competitive market with open competition with *floor rates*

approved by the Insurance Commissioner and based on loss costs from the WCIRB. Prior approval from CDI was recommended for an insurer to go below the floor rates. The Commission was concerned that there would be cut-throat price wars. The open rating system that was enacted did not include the protective feature of “floor rates”. Consequently, the same basic rate regulatory structure remains in place, which could possibly allow a new round of cut throat pricing.

The reforms have made major strides in trying to address the outside cost drivers in the workers’ compensation system. Most of the Commission’s major recommendations have been implemented—the notable exceptions being the “floor rate” concept and separating the residual market from SCIF.

In the 2002 CHSWC report, “Background Paper State of Workers’ Compensation Insurance Industry in California”, the American Insurance Association cited the following mechanisms as being in place in California to permit the Insurance Commissioner “to protect the solvency of the insurance system”:

1. Authority over the adequacy of the aggregate reserves of an insurer (Insurance Code 923.5 and 11558 and regulations that provide, in part, The minimum reserve requirements prescribed in Section 11558 shall be increased whenever the Commissioner determines that the computations set forth in “Section 11558 are inadequate as provided in Section 11557.”
2. Authority to require insurers to increase reserve whenever reserves “seem inadequate”. (Insurance Code 11557)
3. Authority to require insurers to provide additional accounting or actuarial information regarding its financial condition whenever the insurer appears to require immediate regulatory attention. The additional accounting or actuarial supplementary information may be at such intervals as the Commissioner may require and must come from such accountants and actuaries as are satisfactory to the Commissioner. (Insurance Code 925).
4. Authority to require an insurer to stop any conduct that would render the company insolvent. (Insurance Code 1065.1)
5. Insurance Code 739 et seq. provides an oversight mechanism, Risk-Based Capital (RBC). RBC is a tool that allows the Department to review a number of critical components of an insurers operations to determine whether its financial condition warrants regulatory intervention.
6. Insurance Code 11732 provides that: “(r)ates shall not, if continued in use threaten the solvency of an insurer or tend to create a monopoly in the market.” Some conclude that this only allows intervention in the rates of an insurer when the insurer is faced with impending (if not actual) insolvency. Others believe that the CDI does have significant authority within the overall solvency regulation scheme in the Insurance Code to allow early intervention in an insurer’s rate making when its other financial indicators, such as loss ratios, reserve adequacy, and loss development, are adequately reviewed and analyzed.

However, even with these statutes by the time the Commissioner can act (after allowing for to the carrier involved), it may be too late to prevent an impending insolvency.

Additional statutory authority should be considered which would give the Commissioner the authority to take a series of steps when evidence of predatory pricing exists. Likewise, certain insurers which meet predetermined financial standards could make significant deviations from the CDI approved pure premium rates without any type of prior approval. For example, regulations could be considered which would permit insurers to use rates and credits below a floor, provided the insurer meets a minimum credit rating by one or more of the insurance carrier credit rating agencies. Should the credit rating drop to a lower rating (or if other financial requirements are not maintained), the regulation would then limit the carrier's ability to set rates below a WCIRB determined floor. Similarly, regulatory restrictions might be placed on carriers that meet other predetermined financial criteria to issue deductible policies or retrospective rated policies. Regulations do not have to be of the "one size fits all" type, but rather could be very detailed in the requirements for a workers' compensation carrier depending upon the financial strength of the carrier. In addition, the Commissioner might not regulate reinsurance contracts as tightly for the financially strong carrier, than he or she would for a less financially strong insurer.

Improved Oversight

It is beyond the purview of this study to evaluate the capability of CDI to prevent another destructive pricing cycle, or its capability of preventing excessive "profiteering" by the industry (although the regulatory authority to control profits of insurers does not appear to exist, except in a general sense under the prohibition against excessive rates).

Insurance rates and pricing are only part of the workers' compensation system. There are just as many potential subject areas for regulations in the scope and adequacy of workers' compensation benefits, the dispute resolution process, occupational safety and health incentives, and oversight of the management of carriers themselves that can improve the stability of the entire system. Each of these areas is regulated in part by separate agencies in government. After such a major reform in the workers compensation system as took place in 2002-2004, perhaps it is time for the creation of a blue ribbon commission or a high level interagency task force" composed of representatives of CDI, DIR, DWC, Cal/OSHA, SCIF, CIGA, CHSWC, self-insurers, insurers, agents and brokers, labor, employers and the public to develop proposals on how to comprehensively integrate and regulate the many facets that come together as the workers' compensation system. Alternative methods to better regulate rates and prices by carriers might be the first of many complex questions that such a commission or task force might be able to examine in depth and propose detailed statutory or regulatory solutions in periodic reports to the Governor and Legislature.

Other states, such as Michigan and Texas, have delegated industry oversight to existing agencies or newly created committees, with the charge to monitor and report on such key components of the workers' compensation regulatory system as:

- The level of market competition

- The effects of legislative and regulatory changes (from both a regulatory and cost basis)
- The pricing practice of insurers (with particular attention to predatory underpricing and price gauging if it is determined that adequate competition does not exist).

There are existing state agencies in California that look at various pieces of each of these key areas to some degree. However, there is not a centralized source for the overall evaluation of the workers' compensation system in California. It may be appropriate to consider a more coordinated approach.

Chapter IX Endnotes

¹ State Agency Budgets; 2006-2007 Governor's Proposed State Budget, January 2006

² State Agency Budgets; January 2006

³ Wcirbonline; About WCIRB, 2006

⁴ State Agency Budgets; January 2006

⁵ State Agency Budgets; January 2006

⁶ Stage Agency Budgets; January 2006

⁷ State Agency Budgets; January 2006